

Nord Stream 2: It's Time to Change Perspective

The debate around the Nord Stream 2 gas pipeline is overly politicized. A change in perspective is needed. In the long term, Ukraine as the country most affected could strengthen its position by developing into a green energy producer within the European energy market.

By Jeronim Perović and Maria Shagina

The Nord Stream 2 pipeline was initiated in 2015, amidst rising tensions between Russia and the West due to Russia's annexation of the Crimean peninsula and its military intervention in eastern Ukraine. Immediately after the project was signed, it triggered European and transatlantic debates about the pipeline's necessity and its larger geopolitical implications. Proponents of Nord Stream 2 pointed to the need for more gas imports due to falling domestic production and the volatilities of supplies. In the case of Germany, the most adamant supporter and through its companies Uniper and Wintershall Dea also a key stakeholder in Nord Stream 2, political motives played a large role as well: Berlin considers energy an important link to Russia in light of the deteriorating relationship of the two countries. For the opponents – the US, Poland and Ukraine being the most vocal – Nord Stream 2 contradicts the EU's stated objective on diversification of supply sources and undermines Europe's energy security. The gas project has also raised legitimate concerns about its compatibility with the EU's sanctions policy against Russia. The Russian regime's increased repression against the political opposition, including the poi-

soning and imprisonment of Alexei Navalny, has recently strengthened the camp of those who advocate tightening sanctions against Russia, including calls for an immediate halt to the construction of Nord Stream 2. Moreover, the coronavirus pandemic has galvanized the EU's commit-

Key Points

- ▮ Extraterritorial sanctions against allies may seem like a quick fix, but their implications could be potentially damaging for transatlantic relations. Lessons from Cold War experience are indicative.
- ▮ In the increasingly globalized and liberalized gas markets, regulatory powers and other market measures are more effective in mitigating the implications of Nord Stream 2 than heavy-handed sanctions.
- ▮ In the long term, decarbonization will reduce Europe's dependency on oil and gas imports. In this context, Kyiv should try to leverage its position as a future non-fossil energy producer.
- ▮ The discussion over Nord Stream 2 should be used as an opportunity for the US and EU to cooperate on initiatives that would reduce Europe's dependency on fossil energy and strengthen Ukraine's position as a green energy producer within the European energy market.

ments to reduce the share of fossil fuels and invest in its Green Deal, thus further questioning the utility of Nord Stream 2.

Ukraine plays a crucial role in the Nord Stream 2 debate. Its current leadership is fiercely opposed to the pipeline. If the project is completed, Kyiv will lose up to 3 billion USD in revenue from gas transit fees annually, meaning a major financial loss for a country already in economic troubles and engaged in a costly military conflict in the Donbas region. Due to US pressure and with Germany's support, the continued transportation of Russian gas via Ukraine's existing pipeline is secured thanks to an agreement signed by Gazprom and Ukraine's Naftogaz in December 2019. With this deal, Ukraine will remain a transit country, supplying 40 billion cubic meters (bcm) per year to Europe, at least for the period 2021–2024. The main question is, how-

ever, what happens when the deal expires and Russia has more options to circumvent Ukraine once Nord Stream 2, as well as TurkStream (another gas pipeline under construction), are online. Unlike in the 1990s, when some 80 per cent of Russian gas destined for Europe passed through Ukraine, the Ukrainian transit system will likely remain a residual route for Gazprom's flows of 10–20 bcm or serve as a fallback option for seasonal flexibility.

In any event, it is time to change perspectives on a highly politicized debate and take a long-term approach. Instead of increasing pressure on its European allies, Washington would be well advised to help find solutions for Europe and Ukraine to move away from its heavy dependence on fossil energy. This would lead to reduced dependence on Russian energy, and it would also be in line with overall climate goals of reducing global carbon emissions. At the same time, other measures such as strengthening EU energy regulations and cross-border interconnections may be instrumental in mitigating the geo-economic implications of Nord Stream 2. Ukraine could play a key role in the EU's energy transition due to its vast but largely untapped green energy potential. Therefore, Ukraine is well advised not to lose sight of the broader picture and embrace decarbonization as an opportunity to transform its energy system, strengthen its energy security, and revive its economy.

Cold War Parallels

The highly politicized discussion around the construction of Nord Stream 2 shows striking similarities to discussions in the early 1980s around the construction of the Uren-goy-Uzhgorod gas pipeline, the first Soviet gas export pipeline connecting West Siberia's gas riches directly to the markets of West Germany. The gas pipeline deal aimed



Valves near a drilling rig, operated by Gazprom, at Bovanenkovo gas field on the Arctic Yamal peninsula, May 21, 2019. Maxim Shemetov / Reuters

to supply Siberian gas in exchange for European heavy machinery and large-diameter steel pipes. Washington viewed economic ties with the Soviet Union as detrimental to Europe's energy security. Primary concerns were that hard currency earned from any gas deal would help finance the Soviet military. In contrast, Western Europe, and Germany in particular, saw trade with Moscow as a way of political rapprochement and promotion of mutual trust.

As US-Soviet relations deteriorated, the incoming US administration under President Ronald Reagan adopted a tougher line. In reaction to Poland's declaration of martial law in 1981, the US administration introduced restrictions on high-tech exports and suspended all trade credits to the Soviet Union. European governments opposed these measures, but showed willingness to find a solution. Although the US and Europe seemed to agree on a compromise, it proved to be short-lived due to changes in the US position: The hawks within the US government pushed for a tougher stance, and as a result, the Reagan administration imposed extraterritorial sanctions with a retroactive effect on European companies involved in the pipeline project. Yet, as the US adopted a policy of trade denial on the Europeans, Washington continued exporting agricultural products to the Soviet Union. The unwillingness of the US to share the costs of its own restrictions triggered an unexpected level of resistance from European governments and ultimately undermined the effectiveness of sanctions. The Reagan administration was prompted to scrap the pipeline sanctions already by the end of 1982. The pipeline was completed in 1983.

The Siberian pipeline case is pertinent to the ongoing Nord Stream 2 dispute in several respects. Firstly, without coordination, extraterritorial sanctions have the potential to incur collateral damage on the transatlantic

Background

Nord Stream 2 is a natural gas pipeline currently under construction, with almost 95 per cent completed. It runs largely parallel to the already existing Nord Stream 1, from Russia's Ust-Luga over 1,200 kilometers through the Baltic Sea to Lubmin in Germany. More than 120 companies were initially involved in the construction of Nord Stream 2, which will have a capacity of 55 bcm. In addition to Russia's state company Gazprom, which is the owner of the pipeline, the project is being financed by ENGIE (France), OMV (Austria), Shell (UK/Netherlands), Uniper and Wintershall Dea (both Germany). Due to US sanction threats against the pipeline, more than 20 European companies have by now decided to end their participation in the controversial project.

suppliers of their previously dominant position. The diversification of energy sources, routes, and suppliers as well as new regulatory powers have alleviated the risks of potential cut-offs. Due to growing volumes of LNG from alternative suppliers such as Qatar, Gazprom no longer holds a monopoly on gas exports to Central and Eastern Europe. In addition, a growing number of LNG terminals and cross-border interconnectors has increased flexibility and weakened Russia's ability to weaponize gas flows. Even Ukraine, once heavily dependent on Russian gas imports, now meets its demand via European reverse gas flows.

EU energy market regulation can also mitigate the potentially negative implications of the Nord Stream 2 pipeline.

The EU's robust regulatory powers have already proved effective in curtailing Gazprom's geopolitical ambitions in the past, as Gazprom made concessions on removing destination clauses, allowing gas swaps between European suppliers, and adopted European hubs as the pricing benchmark for deliveries to Central and Eastern Europe. To become operational, Nord Stream 2 will have to comply with the EU's Third Energy Package, which stipulates unbundling (the separation of supply and transit between two independent entities), third-party access, and transparent tariffs. If rigorously implemented, the Third Energy Package can provide the necessary safeguards and be more effective in offsetting the negative impact of Nord Stream 2 than heavy-handed US extraterritorial sanctions.

In addition, other measures of economic statecraft can complement the EU's regulatory powers. This can include building more cross-border interconnectors in

partnership. Through coercion, Washington will not necessarily resolve fundamental disagreements, but merely delay them. Divisions among Western allies will unlikely be beneficial to countries like Ukraine whose interests are served better by a united West. Secondly, by resorting to extraterritorial sanctions, the US might only bolster the EU's resolve to develop its strategic autonomy. The European Commission has already announced its strategy to strengthen resilience to extraterritorial sanctions by promoting the international role of the Euro and strengthening financial market infrastructures. Thirdly, the credibility of sanctions matters. As in 1982, when the credibility of US measures was undermined by an unwillingness to halt grain exports to the Soviet Union, there is a widespread perception today that a key motive behind US sanctions is Washington's desire to sell more of its liquified natural gas (LNG) to Europe. Finally, as the Siberian pipeline crisis illustrates, internal divisions can thwart the negotiated compromise. As the Biden administration currently seeks to work out a package deal over Nord Stream 2 with Germany, it is important for Berlin in order to consolidate its position internally when entering negotiations with the US to avoid running the risk of the discussions being hijacked by domestic political forces or third parties not directly involved in negotiations like Poland and Ukraine.

Globalized Gas Markets

Since the end of the Cold War, energy landscapes have changed dramatically, diminishing Russia's ability to use gas as a tool of political leverage. The gas markets have become more interconnected and liberalized, thus depriving piped gas

Further Reading

Thane Gustafson, *The Bridge: Natural Gas in a Redivided Europe* (Cambridge, MA: Harvard University Press, 2020).
Provides a comprehensive analysis of East-West gas relations.

Oxford Institute for Energy Studies, "The Geopolitics of Energy: Out With the Old, in With the New?", *Oxford Energy Forum* 126, 2021.
Highlights the core power shifts and the main winners and losers that are likely to emerge due to energy transition.

Simon Pirani / Jack Sharples, *Ukraine-EU Gas Market Integration: Short-Term Progress, Long-Term Challenges* (Oxford: Oxford Institute for Energy Studies, 2021).
Discusses the future of the Ukrainian gas transit system.

Eastern Europe, developing LNG infrastructure or financing renewable and hydrogen projects. The Three Seas Initiative, spearheaded by Central European countries and supported by the US, has been specifically designed to counter the geo-economic influence of such projects as Nord Stream 2. The Initiative aims to increase cooperation on infrastructure and energy interconnectivity to create a “North-South” corridor and offset the reliance on the historical “East-West” axis.

Decarbonization and a New Role for Ukraine

In the long term, Nord Stream 2 will not be the main threat to Ukraine’s economic sustainability. Decarbonization trends accelerate worldwide, and more countries pledge to cut their carbon footprint and decrease the share of fossil fuel by 2030. Energy transition will lead to profound geopolitical and structural power shifts.

In Europe, there appear to be strong political and environmental motivations to achieve carbon neutrality goals by 2050. The EU Green Deal seeks to cut net zero carbon emissions by integrating a massive addition of non-fossil fuel power generation and increasing energy efficiency. Energy transition is also set to accelerate a shift to green financing: Major Western banking institutions have pledged to stop funding most fossil fuel projects. An introduction of a carbon border adjustment mechanism to place a carbon price on the import of polluting commodities from non-EU countries will levy an additional burden for gas exporting and transiting countries. As a result, decarbonization will force countries like Ukraine to rethink their energy security and change their economic model based on the reliance on gas transit fees sooner than expected.

To its credit, Ukraine has already become active in catching up with these decarbonization trends. In March 2021, the government published a strategy, aiming to reach net zero emissions by 2060. Kyiv has already started exploring untapped potential in the domestic production of natural gas, biogas, and biomethane that would lower its dependence on energy imports; but creating an attractive investment climate remains key. With the assistance of the World Bank, Kyiv unveiled its plans to launch the Hydrogen Strategy this year. The country’s vast gas storage facilities can be useful in the transition to hydrogen: The facilities may be used for carbon capture and storage. Berlin and

Kyiv signed an energy partnership to improve and build a sustainable energy infrastructure, modernize the electricity sector, transform Ukraine’s coal regions, and launch a pilot hydrogen project in Mariupol.

Russia is not lagging too far behind Ukraine in developing its decarbonization strategy, and Moscow can potentially become Ukraine’s main competitor in supplying hydrogen to the EU. Kyiv should use the Nord Stream 2 discussion to secure collaboration with the EU on the development of green energy projects and lock in Western investments for the modernization of and repurposing of its transmission and distribution infrastructure. Pivoting away from its toxic energy dependency on Russia will help Ukraine to transform its energy system and strengthen its economy and national security in the long term.

Outlook

The Nord Stream 2 pipeline poses a serious challenge for Ukraine’s energy security. How to deal with it has sparked fundamental disagreements between the Western partners. The project has become overly politicized, but it is not the root of the problem, only a symptom. Sanctioning Nord Stream 2 will not quell Russia’s appetite to circumvent Ukraine. Constructing alternative pipelines and supplying hydrocarbons directly to its European customers has been Gazprom’s long-standing policy. Another diversification pipeline – TurkStream – is already under way. In the long term, the pressure from energy transition will undermine the traditional East-West gas transit business sooner than expected. It is in Ukraine’s best interests to revise its economic model and adapt its energy security as soon as possible. Focusing on closer integration with the European market and attracting investments into the modernization and decarbonization of the energy sector will be key.

Jeronim Perović is a Professor at the University of Zurich and Head of the Center for Eastern European Studies (CEES).

Maria Shagina is a Postdoctoral Fellow at the CEES of the University of Zurich.

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Editor: Brian G. Carlson
Assistant Editor: Niklas Masuhr
Layout: Miriam Dahinden-Ganzoni

Feedback welcome: PolicyPerspectives@sipo.gess.ethz.ch
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